(2)

Supreme Court, U.S.
FILED

No. 02 16 54 MAY 8 - 2003

In the

OFFICE OF THE CLERK

Supreme Court of the United States

VETERINARY SURGICAL CONSULTANTS, P.C.,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

APPENDIX

Joseph H. O'Donnell, Jr.
Counsel of Record

116 East Allen Street
Philadelphia, PA 19125
(215) 426-3245
Attorney for Petitioner

38 pp

TABLE OF CONTENTS

	Page(s)
CIRCUIT COURT OPINION	1a to 9a
JUDGMENT OF CIRCUIT COURT (sought to be reviewed)	10a & 11a
U.S. TAX COURT OPINION	12a to 26a
U.S. TAX COURT DECISION	27a & 28a
CIRCUIT COURT ORDER DENYING REHEARING EN BANC	29a & 30a
PERTINENT PORTIONS OF THE TEXT OF FEDERALLY ENACTED STATUTES RELEVANT TO THIS CASE:	
I. PERTINENT PARTS OF FEDERALLY ENACTED STATUTES:	
A. 26 U.S.C. Sec. 1366	31a & 32a
B. 26 U.S.C. Sec. 3121(d)	32a
C. Section 530 of the Revenue Act of 1978	33a & 34a
II. Revenue Procedure 85-18 I.R.B. 1985-13, 27	35a

CORPORATE DISCLOSURE STATEMENT

The Petitioner: VETERINARY SURGICAL CONSULTANTS, P.C., a professional corporation

VETERINARY SURGICAL CONSULTANTS, P.C., the Petitioner which is a nongovernmental corporate party to the proceedings and was a party to the proceedings as the "Petitioner" in the United States Tax Court and the "Appellant" in the United States Court of Appeals for the Third Circuit.

VETERINARY SURGICAL CONSULTANTS, P.C. does not now have nor has ever had any parent or subsidiary corporations, and it is not now nor ever has been the parent corporation of another corporation nor has it ever been a subsidiary corporation of another corporation.

No publicly held corporation nor any other corporation owns or ever has owned 10 percent or more of the stock of VETERINARY SURGICAL CONSULTANTS, P.C..

NOT PRECEDENTIAL

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Case Nos. 02-1132 and 02-1214

YEAGLE DRYWALL COMPANY, INC.,
Appellant in No. 02-1132

v.

COMMISSIONER OF INTERNAL REVENUE

VETERINARY SURGICAL CONSULTANTS, P.C.,
Appellant in No. 02-1214

v.

COMMISSIONER OF INTERNAL REVENUE

On Appeal from the United States Tax Court
(Nos. 00-3908 and 99-2500)
Tax Judge: The Honorable Julian I. Jacobs

Submitted under Third Circuit LAR 34.1
December 3, 2002

Before: ROTH, SMITH and CUDAHY,* Circuit Judges

(Filed: December 18, 2002)

*Honorable Richard Cudahy, Circuit Judge for the United States Court of Appeals for the Seventh Circuit, sitting by designation.

OPINION

D. BROOKS, Circuit Judge:

This consolidated appeal challenges determinations by the United States Tax Court that an officer and shareholder of each of the corporate taxpayers was an employee and that the taxpayer was therefore liable for taxes under the Federal Insurance Contributions Act ("FICA"), 26 U.S.C. Secs. 3101-3128, and the Federal Unemployment Tax Act ("FUTA"), 26 U.S.C. Secs. 3301-3311. For the reasons set forth below, we will affirm.

I.

The taxpayers, Veterinary Surgical Consultants, P.C. ("VSC") and Yeagle Drywall Company, Inc. ("YDC"), both received from the Internal Revenue Service ("IRS") a "Notice of Determination Concerning Worker Classification Under Section 7436." VSC's notice, dated November 17, 1998, advised that the IRS had determined that Kenneth K. Sadanaga, D.V.M., was to be classified as an employee for purposes of federal employment taxes for all quarters in 1994, 1995 and 1996 and that the taxpayer was not "entitled to relief from this classification pursuant to section 530 of the Revenue Act of 1978." VSC filed a timely petition for redetermination with the United States Tax Court and the parties stipulated to the facts. The stipulation established that the taxpayer was a subchapter "S" corporation which provided consulting and surgical services to vaterinarians. The corporation was solely owned by Dr. Sadanga, who was also its president and its only officer since incorporation. He alone performed the veterinary services rendered by VSC. In addition to his

professional services, Dr. Sadanga managed the business, performing all the administrative tasks.

VSC did not make regular payments to Dr. Sadanga for his services. Instead the money from VSC's bank account was withdrawn by Dr. Sadanga as the need arose. The payments were not listed by VSC on its federal Form 1120S return as compensation to its officer or as wages. Instead, VSC computed its ordinary income and Dr. Sadanga indicated this amount as non-passive income on the Schedule K-1 of his Form 1040 Return. The non-passive income on his returns for 1994, 1995, and 1996, respectively, was $83,995.50, $173,030.39, and $161,483.35.

The IRS issued its Notice of Determination Concerning Worker Classification to YDC in February, 2000, advising that John Yeagle was classified as an employee for calendar years 1995, 1996, and 1997. Yeagle owned 99% of the business, with the remaining 1% in his wife's name. Yeagle was president of his business since its incorporation and performed the following services: soliciting business; ordering supplies; executing agreements; managing finances; and hiring and firing independent contractors.

Yeagle, like Sadanaga, did not receive payments from his company on a regular basis. Rather, Yeagle "would take money from [YDC's] bank account as Mr. Yeagle's needs arose and/or would pay personal expenses from such account as he desired." Like VSC, Yeagle Drywall did not pay employment taxes for the services rendered by its owner, John Yeagle. Instead, it filed a Form 1120S reflecting the income earned by the corporation and Yeagle indicated that amount as non-passive income on the Schedule K-1 of his Form 1040 Return. The non-passive income reported for 1995, 1996, and 1997, respectively, was $26,711.08, $32,973.39, and $34,508.90.

Based on these stipulated facts, the Tax Court determined, in separate decisions, that the IRS had not erred in classifying Dr. Sadanga and John Yeagle as employees under the FICA and the FUTA. It found that the payments received by Dr. Sadanga and Yeagle were remuneration for the substantial services performed on behalf of the corporate taxpayer and that VSC and YDC were liable for the unpaid FICA and FUTA taxes. The Tax Court also concluded that neither taxpayer could obtain relief from the taxes due under the safe harbor established by section 530 of the Revenue Act of 1978.

II.

We have "exclusive jurisdiction" under 26 U.S.C. Sec. 7482(a)(1) "to review the decisions of the Tax Court. . .in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury[.]" 26 U.S.C. Sec. 7482(a)(1). "Thus, we have plenary review over the Tax Court's findings of law, including its construction and application of the Internal Revenue Code." **PNC Bancorp, Inc. v. Commissioner of Internal Revenue**, 212 F.3d 822, 827 (3d Cir. 2000).

III.

FICA and FUTA impose taxes on employers based on the wages paid to individuals in their employ. 26 U.S.C. Secs. 3111, 3301. "Wages" is defined broadly by both Acts, with certain exceptions not applicable here, as "all remuneration for employment[.]" 26 U.S.C. Secs. 3121(a), 3306(b). Employment is defined as "any service of whatever nature, performed.. .by an employee for the person employing him[.]" 26 U.S.C. Secs. 3121(b), 3306(c). FICA also defines "employee," in pertinent part, as:

> (1) any officer of a corporation; or
> (2) any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee[.] 26 U.S.C. Sec. 3121(d).

Treasury regulation Sec. 31.3121(d)-1(b) restates the general rule that an officer of a corporation is an employee of the corporation and specifies that there is an exception for an "officer of a corporation who as such does not perform any services or performs only minor services and who neither receives nor is entitled to receive, directly or indirectly, any remuneration[.]" 26 C.F.R. Sec. 31.3121(d)-1(b).

Consistent with this law, the Tax Court focused on whether the distributions of income made by VSC and YDC were remuneration for the services performed by Dr. Sadanga and John Yeagle. The court found that each of these individuals performed substantial services for the corporate taxpayers and that the distributions of income received were, in fact, remuneration for the services rendered. Accordingly, it held that the taxpayers were liable for federal employment taxes under the FICA and the FUTA.

We agree. Under the FICA, an officer of a corporation is an employee unless he performs only minor services. 26 U.S.C. Sec. 3121(d)(1); 26 C.F.R. Sec. 31.3121(d)-1(b). Dr. Sadanga's services were anything but minor inasmuch as he was the only source of revenue for VSC and performed all of the administrative tasks. Likewise, John Yeagle managed and directed all of the activities undertaken by YDC. Because these services were substantial, the Tax Court did not err in concluding that the distributions of income paid by the corporate taxpayers were remuneration for services rendered, thereby

constituting wages under the FICA and the FUTA.

The Ninth Circuit's decision in **Spicer Accounting, Inc. v. United States**, 918 F.2d 90 (9th Cir. 1990), is instructive. There, the court determined that the dividends paid by an S corporation to a shareholder, who was also an officer and the only certified public accountant performing services for the business, were wages. It relied upon: (1) treasury regulations which provide that the "form of payment is immaterial, the only relevant factor being whether the payments were actually received as compensation for employment," id. (citing 26 C.F.R. Secs. 31.3121(a)-1(b), 31.3306(b)-1(b)); (2) the definition of employee in Sec. 3121(d)(1); and (3) the exception contained in the treasury regulation for officers performing minor services, 26 C.F.R. Sec. 31.3121(d)-1(b). Because Mr. Spicer was the only individual providing accounting services to the corporation and these services were substantial, the court concluded that the dividends were remuneration and subject to federal employment taxes. 918 F.2d at 92-93; see also **Joseph Radtke, S.C. v. United States**, 895 F.2d 1196 (7th Cir. 1990).

The taxpayers argue, however, that the Tax Court erred because it failed to consider whether, under the stipulated facts, Dr. Sadanga and John Yeagle were employees "under the usual common law rules applicable in determining the employer-employee relationship," as provided by Sec. 3121(d)(2). They rely upon **Texas Carbonate Co. v. Phinney**, 307 F.2d 289 (5th Cir. 1962), which conducted an employer-employee analysis, consistent with Sec. 3121(d)(2), despite the fact that the purported employee was an officer of the corporate taxpayer.

Reliance upon **Texas Carbonate** is misplaced for two reasons. First, it is neither binding nor

authoritative in light of its failure to apply the plain language of Sec. 3121(d) which defines employee by using the conjunction "or" between subparagraphs (1) and (2). This conjunction signifies an intent that an individual may qualify as an employee under either set of circumstances. Here, Dr. Sadanga and John Yeagle satisfy the criteria set forth in Sec. 3121(d)(1) and the applicable treasury regulation Sec. 31.3121(d)-1(b), thereby obviating any reason to analyze whether they are employees under the usual common law rules under subparagraph (2). It is important to point out that by rejecting the taxpayers' argument, we are avoiding an interpretation of Sec. 3121(d) which would render subparagraph (1) superfluous. See **Rosenberg v. XM Ventures**, 274 F.3d 137, 141 (3d Cir. 2001).

Second, despite the **Texas Carbonate** court's failure to recognize the applicability of Sec. 3121(d)(1), its analysis considered whether the services of the officer, in the absence of any control by the corporation, were substantial. It pointed out that the officer was a stockholder, a director, and a manager of the company, in charge of its sales, and the development of its markets. These services, in the court's view, were substantial and justified the determination that: (1) the officer was an employee; and (2) the corporation was liable for federal employment taxes. 307 F.2d at 292-93.

IV.

Under Section 530 of the Revenue Act of 1978, there is a safe harbor for taxpayers who owe FICA and FUTA taxes as a result of wrongfully failing to classify certain individuals as employees. See P.L. 95-600, as amended by P.L. 96-167, P.L. 96-541, P.L. 97-248, P.L. 99-514 and P.L. 104-188 (hereinafter cited as "Section 530"). This uncodified section relieves a taxpayer of certain federal employment

tax liabilities arising from a failure to treat an individual as an employee if the taxpayer had a "reasonable basis for not treating such individual as an employee." Section 530 (a)(1): **303 West 42nd St. Enter., Inc. v. I.R.S.**, 181 F.3d 272, 274 (2d Cir. 1999). Section 530(a)(2) specifies thst a taxpayer shall be treated as having a reasonable basis for not treating an individual as an employee if it reasonably relied on:

> (A) judicial precedent, published rulings, technical advice with respect to the taxpayer, or a letter ruling to the taxpayer;
> (B) a past Internal Revenue Service audit of the taxpayer[;] or
> (C) long standing recognized practice of a significant segment of the industry in which such individual was engaged.

Section 530 (a)(2)

Here, the taxpayers assert that the Tax Court improperly determined that they were not entitled to relief under this safe harbor provision. They contend that there was a reasonable basis for not treating Dr. Sadanga and John Yeagle as employees, citing the judicial precedent in **Texas Carbonate**, 307 F.2d at 289.

As we explained above, **Texas Carbonate** is not authoritative and it does not support the taxpayers' argument that Dr. Sadanga and John Yeagle were not employees. Thus, any reliance upon **Texas Carbonate** by either VSC or YDC was unreasonable, particularly in light of the subsequent decisions in **Radtke**, 895 F.2d at 1197-98, and **Spicer Accounting**, 918 F.2d at 94-95. Indeed, **Spicer Accounting** rejected the taxpayer's argument that it had a reasonable basis for not treating its officer as an employee under Section 530 and should not be held liable. The court reasoned that Mr. Spicer was "for all

practical purposes, the central worker for the taxpayer" and it declared that a "corporation's sole full-time worker must be treated as an employee." 918 F.2d at 95.

Finally, the taxpayers argue that their due process rights were violated because the IRS failed to give written notice of the provisions of Section 530 at either audits. This argument was not raised before the Tax Court and we will not consider it for the first time on appeal. **Harris v. City of Philadelphia**, 35 F.3d 840, 845 (3d Cir. 1994).

V.

Accordingly, because Dr. Sadanga and John Yeagle were properly classified by the IRS as employees of VSC and YDC, respecively, and there was no reasonable basis for not treating them as employees, we will affirm the decision of the Tax Court.

To the Clerk of Court:

Please file the foregoing Opinion.

"s/ D. Brooks Smith "

Circuit Judge

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Case Nos: 02-1132 and 02-1214

YEAGLE DRYWALL COMPANY, INC.,
Appellant in No. 02-1132

V.

COMMISSIONER OF INTERNAL REVENUE

VETERINARY SURGICAL CONSULTANTS, P.C.,
Appellant in No. 02-1214

V.

COMMISSIONER OF INTERNAL REVENUE

On Appeal from the United States Tax Court
(Nos. 00-3908 and 99-2500)
Tax Judge: The Honorable Julian I. Jacobs

Submitted under Third Circuit LAR 34.1
December 3, 2002

Before: ROTH, SMITH and CUDAHY*, Circuit Judges

*Honorable Richard Cudahy, Circuit Judge for the United States Court of Appeals for the Seventh Circuit, sitting by designation.

JUDGMENT

These cases came to be heard from the United States Tax Court and were submitted on December 3, 2002. On consideration whereof, it is now here

ORDERED AND ADJUDGED by this court that the Memorandum Opinions and Orders entered by the United States Tax Court on October 15, 2001, be and the same are hereby AFFIRMED.

ATTEST:

"s/Kathleen Brouwer"
Acting Clerk

Dated: December 18, 2002

Certified as a true copy and issued in lieu of a formal mandate on 3/13/03

Teste: "s/Kathleen Brouwer "

Chief Deputy Clerk, U.S. Court of Appeals for the Third Circuit.

117 T.C. No. 14

UNITED STATES TAX COURT

VETERINARY SURGICAL CONSULTANTS, P.C.,
Petitioner v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

Docket No. 2500-99 Filed October 15, 2001.

P, an S corporation, distributed all of its net income to A, its sole shareholder and president. A performs substantial services for P. On his forms 1040, A reported P's net income as nonpassive income from an S corporation.

R issued to P a Notice of Determination Concerning Worker Classification Under Sec. 7436, determining that A was an employee of P for purposes of Federal employment tax.

Held: A is an employee of P for purposes of Federal employment tax pursuant to sec. 31.3121(d)-(1)(b). Employment Tax Regs., because A is an officer who performs substantial services for P and receives remuneration for those services.

Held, further, P is not entitled to relief pursuant to Sec. 530 of the Rev. Act of 1978, Pub. L. 95-600, 92 Stat. 2763, 2885, because P did not have a reasonable basis for not treating A as an employee.

Joseph H. O'Donnell, Jr., for petitioner.

Kathleen K. Raup, for respondent.

OPINION

Jacobs, Judge: This case is before the Court on a petition for redetermination of a Notice of Determination Concerning Worker Classification

Under Section 7436 (Notice of Determination). It was submitted to the Court fully stipulated under Rule 122. The sole issue to be decided is whether Kenneth K. Sadanaga, D.V.M. (Dr. Sadanaga), is an employee of petitioner for the period at issue (each of the four quarters of 1994, 1995, and 1996) for purposes of Federal employment taxes. For convenience, we use the term "Federal employment tax" to refer to taxes under sec. 3101-3125 (enacted as Federal Insurance Contributions Act (FICA), ch. 9, 53 Stat. 175 (1939)) and secs. 33301-3311 (enacted as Federal Unemployment Tax Act (FUTA), ch. 9, 53 Stat. 183 (1939)).

Background

The stipulation of facts and the attached exhibits are incorporated herein. The stipulated facts are hereby found.

Petitioner is an S corporation that was incorporated in Pennsylvania on May 22, 1991. At the time petition was filed, petitioner's principal place of business was in Malvern, Pennsylvania. Petitioner's only business is providing consulting and surgical services to veterinarians. Dr. Sadanaga is petitioner's sole shareholder and serves as its president, petitioner's only officer.

Since petitioner's incorporation, all of its income has been generated from the consulting and surgical services provided by Dr. Sadanaga to Veterinary Orthopedic Services, Ltd. (Orthopedic). During the period at issue, Dr. Sadanaga spent at least 33 hours per week providing consulting and surgical services on behalf of petitioner. He performed surgeries at the Veterinary Referreal Center in Frazer, Pennsylvania, and consulted with veterinarians in their offices or his home.

Dr Sadanaga is the only person with signature

authority on petitioner's bank account. Dr. Sadanaga handled all of petitioner's correspondence and performed all administrative tasks on behalf of petitioner. Petitioner did not make regular payments to Dr. Sadanaga; rather, Dr. Sadanaga withdrew money from petitioner's bank account at his discretion.

Petitioner received a form 1099-MISC, Miscellaneous Income, from Orthopedic reporting "non-employee compensation" during each of the quarters at issue. The Forms 1099-MISC reported that Orthopedic paid petitioner $125,152.63 in 1994, $225,469.24 in 1995, and $212,863. in 1996. Petitioner reported the amount reflected on the Forms 1099-MISC as its total gross receipts on its Form 1120S, U.S. Income Tax Return for an S Corporation, for 1994, 1995, and 1996.

On Forms 1120S, petitioner reported net income from its trade or business for 1994, 1995, and 1996 in the respective amounts of $83,995.50, $173,030.39, and $161,483.35. Petitioner paid these amounts to Dr. Sadanaga, and reported these amounts as Dr. Sadanaga's share of its income on Schedules K-1, Shareholders' Shares of Income, Credits, Deductions, etc., of the Forms 1120S. Petitioner reported on Schedules M-2, Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed, of the Forms 1120S, that the amounts it paid to Dr. Sadanaga were distributions other than dividend distributions paid from accumulated earnings and profits.

Petitioner did not issue a Form 1099-MISC or a Form W-2, Wage and Tax Statement, to Dr. Sadanaga for 1994, 1995, or 1996. Nor did Petitioner file a form 941, Employer's Quarterly Federal Tax Return, or a Form 940, Employer's Annual Federal Unemployment Tax Return, for any quarter during the period at issue. On Schedules

E, Supplemental Income and Loss, of Dr. Sadanaga's 1994, 1995, and 1996 Forms 1040, U.S. Individual Income Tax Returns, Dr. Sadanaga reported his share of petitioner's income (as indicated on the Schedules K-1) as nonpassive income from an S corporation.

Dr. Sadanaga was a full-time employee of Bristol-Myers Squibb Co. (Bristol-Myers). He reported wages from Bristol-Myers of $91,212.18 in 1994, $95,891.15 in 1995, and $102,031.14 in 1996. In 1994, 1995, and 1996, Bristol-Myers withheld Social Security taxes from Dr. Sadanaga.

Respondent began an audit of petitioner's return for 1995 in May, 1997. On October 22, 1997, Revenue Agent, James Tepper, and petitioner's accountant, Joseph Grey, met to discuss the audit. Revenue Agent Orville Surla joined Revenue Agent Tepper and Mr. Grey to discuss whether Dr. Sadanaga was an employee of petitioner in 1995. Mr. Grey asserted that Dr. Sadanaga was not an employee of petitioner and that distribution to him from petitioner represented his share of petitioner's net income. Mr. Grey objected to any assessment of Federal employment taxes against petitioner. Because Mr. Grey and Revenue Agent Tepper could not reach any agreement with respect to the Federal employment tax issue, the issue was referred to Revenue Agent Surla.

On March 16, 1998, respondent sent petitioner a 30-day letter, proposing adjustments to petitioner's Federal employment taxes for each of the four quarters of 1994, 1995, and 1996. On April 3, 1998, petitioner submitted to respondent a letter protesting the proposed adjustments.

On October 5, 1998, respondent sent petitioner a letter advising that there would be no change resulting from the audit of petitioner's Form 1120S for 1995. On November 17, 1998, respondent issued to petitioner a Notice of

of Determination, in which respondent determined that (1) Dr. Sadanaga was an employee of petitioner for purposes of Federal employment taxes, and (2) petitioner was not entitled to "safe harbor" relief from these taxes as provided by section 530 of the Revenue Act of 1978, Pub. L. 95-600, 92 Stat. 2885 (Section 530). Attached to the Notice of Determination was a schedule detailing the amount of the proposed Federal employment taxes. Thereafter, petitioner filed with the Court a timely petition seeking our review of respondent's Notice of Determination.

Discussion

Petitioner contends that Dr. Sadanaga was not its employee and that it properly distributed its net income to Dr. Sadanaga, as its sole shareholder, pursuant to section 1366. On the other hand, respondent contends that Dr. Sadanaga was an employee of petitioner because he was an officer of petitioner and performed substantial services on petitioner's behalf.

Sections 3111 and 3301 impose FICA (Social Security) and FUTA (unemployment) taxes on employers for wages paid to their employees. For Federal employment tax purposes, Section 3121(d) defines an employee in part as any officer of a corporation. However, there is an exception to employee status for an officer who does not perform any services (or performs only minor services) and who neither receives nor is entitled to receive remuneration. Sec. 31.3121(d)-(1)(b), Employment Tax Regs. For Federal employment tax purposes, the term "wages" is defined as "all remuneration for employment". There are some exceptions to this definition that are not relevant to this case. Secs. 3121(a), 3306(b). The form of payment is immaterial, the only relevant factor being whether the payments were actually received as compensation for

employment. 31.3121(a)-1(b), 31.3306(b)-1(b), Employment Tax Regs. Consequently, an officer who performs substantial services for a corporation and who receives remuneration in any form for those services is considered an employee, whose wages are subject to Federal employment taxes.

With respect to the case at hand, Dr. Sadanaga is an officer of petitioner, and therefore he is an employee of petitioner under the general rule of section 3121(d)(1). Additionally, Dr. Sadanaga performed substantial services for petitioner, working approximately 33 hours a week for petitioner. Indeed, he was the only individual working for petitioner. Tellingly, all of petitioner's income was generated from the consulting and surgical services provided by Dr. Sadanaga.

Petitioner contends that the amounts paid to Dr. Sadanaga were distributions of its corporate net income, rather than wages. Petitioner posits that as an S corporation it passed its net income to Dr. Sadanaga, as its sole shareholder, pursuant to section 1366. Petitioner's argument is flawed. Section 1366 only permits use of S corporation passthrough items in calculating tax liability under chapter 1, not tax liability under chapters 21 and 23--in which the Federal employment tax provisions for FICA and FUTA are located. Sec. 1366(a)(1); see also Ding v. Commissioner, 200 F.3d 587, 590 (9th Cir. 1999), aff'g. T.C. Memo 1997-435; **Catalano v. Commissioner**, T.C. Memo. 1998-447.

Dr. Sadanaga performed substantial services on behalf of petitioner. The characterization of the payment to Dr. Sadanaga as a distribution of petitioner's net income is but a subterfuge for reality; the payment constituted remuneration for services performed by Dr. Sadanaga on behalf of petitioner. An employer cannot avoid Federal employment taxes by characterizing compensation

paid to its sole shareholder as distributions of the corporation's net income, rather than wages. Regardless of how an employer chooses to characterize payments made to its employees, the true analysis is whether the payments represent remuneration for services rendered. **Spicer Accounting, Inc. v. United States**, 918 F.2d 90 (9th Cir. 1990); **Joseph Radtke, S.C. v. United States**, 895 F.2d 1196 (7th Cir. 1990).

Dr. Sadanga's reporting the distribution as nonpassive income from an S corporation has no bearing on the Federal employment tax treatment of those wages. He was petitioner's sole source of income. And as petitioner's sole full-time worker he must be treated as an employee. **Spicer Accounting, Inc. v. United States**, supra at 94-95. Accordingly, we hold that Dr. Sadanaga is an employee of petitioner for the period at issue and, as such, the payments to him from petitioner constitute wages subject to Federal employment taxes.

Despite our determination that Dr. Sadanga is an employee of petitioner, and that the payments to him from petitioner are wages subject to Federal employment taxes, Section 530 allows petitioner relief from employment tax liability if two conditions are satisfied. Section 530(a)(1) provides in relevant part:

> (1) In general.--If
>
> > (A) for purposes of employment taxes, thetaxpayer did not treat an individual as an employee for any period * * *, and
> >
> > (B) in the case of periods after December 31, 1978, all Federal tax returns (including information returns) required to be filed by the taxpayer with respect to such individual for such period are filed on a basis consistent with the taxpayer's treatment of such

> individual as not being an employee, then for purposes of applying such taxes for such period with respect to the taxpayer, the individual shall be deemed not to be an employee unless the taxpayer had no reasonable basis for not treating such individual as an employee.

Here, the first of the two conditions is satisfied. Petitioner did not treat Dr. Sadanga as an employee during the period in issue. Since its incorporation, petitioner filed its tax returns reflecting all withdrawals by Dr. Sadanga as distributions of petitioner's income, not wages.

However, the second condition of Section 530(a)(1) is not satisfied because petitioner had no reasonable basis for not treating Dr. Sadanga as an employee. For purposes of Section 530(a)(1), a taxpayer is treated as having a reasonable basis for not treating an individual as an employee if the taxpayer's treatment of the individual was in reasonable reliance on judicial precedent, published rulings, technical advice with respect to the taxpayer, a letter ruling to the taxpayer, or longstanding recognized practice of a significant segment of the industry in which the individual was engaged. Section 530(a)(2).

Section 3 of Rev. Proc. 85-18, 1985-1 C.B. 518, provides several alternative standards that constitute safe havens in determining whether a taxpayer has a reasonable basis for not treating an individual as an employee. The revenue procedure provides that reasonable reliance on any one of the following safe havens is sufficient:

> (A) judicial precedent or published rulings, whether or not relating to the particular industry in which the

> taxpayer is engaged, or technical advice, a letter ruling, or a determination letter pertaining to the taxpayer; or
>
> (B) a past Internal Revenue Service audit (not necessarily for employment tax purposes) of the taxpayer, if the audit entailed no assessment attributable to the taxpayer's employment tax treatment of individuals holding positions substantially similar to the position held by the individual whose status is at issue * * *; or
>
> (C) long-standing recognized practice of a significant segment of the industry in which the individual was engaged * * *.

A taxpayer who fails to meet any of the safe havens is still entitled to relief if the taxpayer can demonstrate, in some other manner, a reasonable basis for not treating the individual as an employee. Id.

Here, petitioner asserts that its position is supported by the following excerpt from **Durando v. United States**, 70 F.3d 548, 552 (9th Cir. 1995):

> [It is] improper to treat income earned by a corporation through its trade or business as though it were earned directly by its shareholders, even when, as here, the shareholders' services help to produce that income. An S corporation's income passes through to its shareholders not because they helped to create that income, but because they are shareholders.

The excerpt relied upon by petitioner does not support petitioner's position. Respondent is not attempting to treat petitioner's income as though the income were earned directly by Dr. Sadanga. Rather, the issue in this case is whether the distributions paid to Dr. Sadanga are

wages paid to Dr. Sadanga as an employee of petitioner.

Petitioner asserts that **Durando v. United States**, supra, holds that an S corporattion shareholder is not an employee for purposes of deducting contributions to a Keogh plan. Keogh plans are retirement plans for self-employed individuals. A self-employed individual can deduct contributions to a qualified retirement plan up to a limit of 15 percent of his or her earned income. Sec. 404(a)(3)(A), (8)(D). Petitioner misstates the holding of **Durando v. United States.** Contrary to petitioner's assertion, the taxpayers in the **Durando** case did not claim to be employees of an S corporation. Rather, such taxpayers were self-employed individuals, who in that capacity earned income reportable on Schedule C, Profit (or Loss) From Business or Profession, and were shareholders in several S corporations. They claimed Keogh retirement plan deductions by adding their shares of income from the several S corporations to the amounts reported on their Schedule C and taking a deduction of 15 percent of the total. The Commissioner disallowed the deductions attributable to the income from the S corporations. The taxpayers' Keogh plans were not qualified plans established by the S corporations for their employees. Citing section 1372, the court specifically noted that "S corporations can establish retirement plans for their employees, including those who are also shareholders" and that shareholders "who provide services to an S corporation can be treated like employees and covered by that corporation's retirement plan." **Durando v. United States**, supra, at 551. In sum, the **Durando** case does not provide a reasonable basis for not treating Dr. Sadanga as an employee.

Petitioner also relies on Rev. Rul. 59-221, 1959-1 C.B. 225. Rev. Rul. 59-221, supra, holds

that where a small business corporation elects under section 1372 not to be subject to Federal income tax, the amount of its income required to be included in each shareholder's gross income does not constitute "net earnings from self-employment" to such shareholders for purposes of the Self-Employment Contributions Act. That ruling, like the **Durando** case, deals with whether amounts a shareholder receives are derived from a trade or business carried on by the shareholder. In the case at hand, the issue is whether an officer is an employee of a corporation. Rev. Rul. 59-221, supra, makes no mention of either corporate officers or their Federal employment tax status. Therefore, the ruling does not provide a reasonable basis for treating Dr. Sadanga other than as an employee.

Petitioner attempts to distinguish the facts in this case from cases holding that officers who performed substantial servivces for an S corporation are employees for purposes of Federal employment taxes. In **Spicer Accounting, Inc. v. United States**, 918 F.2d 90 (9th Cir. 1990), and **Radtke v. United States**, 895 F.2d 1196 (7th Cir. 1990), the corporations characterized payments to their officer/shareholders as dividends rather than wages. In those cases, the courts found that the payments were in reality remuneration for employment and therefore subject to Federal employment taxes. **Spicer Accounting, Inc. v. United States**, supra at 93; **Radtke v. United States**, supra at 1197. Petitioner attempts to distinguish its case from the **Spicer** and **Radtke** cases because petitioner reported the payment to Dr. Sadanga as a distribution of its net income, which Dr. Sadanga reported as nonpassive income from an S corporation. But as stated previously, we find that the distributions were remuneration for services provided by Dr. Sadanga. Thus, the "dividends" in the **Spicer** and **Radtke** cases are

indistinguishable from the distributions in this case.

Petitioner also misstates the findings and conclusions of this Court in **Joly v. Commissioner**, T.C. Memo. 1998-361, aff'd. without published opinion 211 F.3d 1269 (6th Cir. 2000). Petitioner asserts that the corporation in the **Joly** case was compelled to treat income distributed to its shareholders as wages for the reason that the corporation and shareholders could not prove that any stock was issued to the shareholders. To the contrary, the Court found that part of the distributions to the two shareholders was compensation for services and, thus, constituted wages subject to Federal employment taxes. The balance of the distribution was taxable under section 1368 as gain from the sale or exchange of property to the extent the distributions exceeded the shareholders' bases in their stock. The Court found that the shareholders had not established that their bases in their corporate stock at the beginning of the first taxable year before the Court was other than zero. But there was no question as to the shareholders' ownership of the stock of the corporation.

Petitioner next cites for support the following excerpt from Rev. Rul. 71-86, 1971-1 C.B. 285: "The president and sole shareholder, except for qualifying shares, of a closely held corporation is an employee of the corporation for [Federal] employment tax purposes, notwithstanding that he sets his own salary and prescribes his own duties." Petitioner contends: (1) Rev. Rul. 71-86, supra, exempts the sole shareholder of an S corporation from Federal employment taxes with regard to any income distributed to the "qualifying shares" shareholder, and (2) Dr. Sadanga is such a shareholder because he holds all of the stock in the corporation. Petitioner again misreads the

the revenue ruling. The individual at issue in that revenue ruling owned all the stock of the corporation, except for qualifying shares. The revenue ruling did not define "qualifying shares". (We note, however, that the term generally refers to shares issued to an individual in order to qualify the individual as an incorporator or director where an incorporator or director is required to own stock in the corporation. See, e.g., **Roche's Beach, Inc. v. Commissioner**, 35 B.T.A. 1087 (1937); 2 Fletcher Cyclopedia of the Law of Private Corporations, secs. 297-306 (perm. ed., rev. vol. 1998).) Here, Dr. Sadanga owns all the shares of petitioner's stock, and there is no evidence that any shares were issued solely to qualify Dr. Sadanga as a director or an incorporator. Rev. Rul. 71-86, supra, supports respondent's position; it does not provide an exception for petitioner.

Finally, petitioner argues that section 1372 prohibits a 2-percent shareholder of an S corporation from being treated as an employee of the S corporation. Section 1372, however, applies only to the provisions of subtitle A, income taxes, not subtitle C--in which Federal employment tax provisions are located.

In Rev. Rul. 73-361, 1973-2 C.B. 331, an officer/stockholder of a small business corporation performing substantial services as an officer of the corporation was held to be an employee of the corporation for purposes of Federal employment taxes. Rev. Rul. 73-361, supra, states:

> Neither the election by the corporation as to the manner in which it will be taxed for Federal income tax purposes nor the consent thereto by the stockholder-officers has any effect in determining whether they are employees or whether payments made to them are "wages" for Federal employment

tax purposes.

In Rev. Rul. 74-44, 1974-1 C.B. 287, two sole shareholders of an electing small business corporation arranged to receive dividends instead of reasonable compensation for services they performed. That revenue ruling held that the "dividends" constituted wages subject to Federal employment taxes.

In this case, respondent's position is supported by the plain language of the statute, the applicable treasury regulations, published revenue rulings, and cases interpreting the applicable statutes. Petitioner's position is inconsistent with the weight of authority.

Petitioner argues that Dr. Sadanga paid the maximum FICA tax required by law in each year at issue and that respondent is attempting to assess additional tax on Dr. Sadanga in the form of withholding taxes. This argument is simply a "red herring". For Federal employment tax purposes, the taxable wage base applies separately to each employer. Thus, if an employee receives wages from more than one employer, the annual wage limitation does not apply to the aggregate compensation received. The employee, however, may be eligible for a credit or refund of the excess employee portion of the FICA tax that applies with respect to wages in excess of the applicable wage base. Secs. 31.3121(a)(1)-1(a)(3), 31.3306(b)(1)-1(a)(3), Employment Tax Regs.

We have considered all of petitioner's arguments, and, to the extent not specifically addressed, we find them unpersuasive or irrelevant.

After the petition was filed in this case, Congress amended section 7436(a) to provide this Court with jurisdiction to determine the correct amounts of Federal employment taxes that relate to the Secretary's determination concerning

worker classification. See Community Renewal Tax Relief Act of 2000 (CRTRA), Pub. L. 106-554, sec. 314(f), 114 Stat. 2763A-643. That amendment was made retroactive to the effective date of section 7436(a). CRTRA sec. 314(g), 114 Stat. 2763A-643.

The parties filed a Stipulation of Settled Issues setting forth the proper amount of Federal employment taxes owed by petitioner in the event we find that Dr. Sadanga is petitioner's employee for purposes of Federal employment taxes (which we do). The amount so stipulated will be reflected in our decision document.

To reflect the foregoing,

Decision will be entered for respondent and in accordance with the parties' stipulations as to amounts.

UNITED STATES TAX COURT
WASHINGTON, D.C. 20217

VETERINARY SURGICAL CONSULTANTS, P.C.	*	
Petitioner,	*	
V.	*	Docket No. 2500-99
	*	**EMPLOYMENT**
COMMISSIONER OF INTERNAL REVENUE	*	
Respondent.	*	

DECISION

Pursuant to the determination of the Court as set forth in its Opinion, filed October 15, 2001, it is

ORDERED and DECIDED that with respect to the Notice of Determination Concerning Worker Classification Under Section 7436, dated November 17, 1998, Dr. Kenneth K. Sadanaga was an employee of petitioner for purposes of Federal employment taxes for the taxable periods 1994, 1995, and 1996.

That petitioner is not entitled to relief under section 530 of the Revenue Act of 1978.

That the amounts of Federal Insurance Contribution Act (FICA) tax imposed under I.R.C. sections 3101 and 3102(a) due from petitioner for the taxable periods 1994, 1995, and 1996 are as follows:

Tax Period Ended	Amount of Tax
March 31, 1994	$1,548.27
June 30, 1994	1,548.27
September 30, 1994	1,548.26
December 31, 1994	1,548.26
March 31, 1995	$2,203.07
June 30, 1995	2,203.07
September 30, 1995	2,203.07
December 31, 1995	2,203.06
March 31, 1996	$2,142.60
June 30, 1996	2,142.60
September 30, 1996	2,142.60
December 31, 1996	2,142.61

That the amounts of Federal Unemployment Tax Act (FUTA) tax imposed under I.R.C. section 3301(a) due from petitioner for the taxable periods 1994, 1995, and 1996 are as follows:

Tax Period Ended	Amount of Tax
December 31, 1994	$434.00
December 31, 1995	434.00
December 31, 1996	434.00

"S/Julian I. Jacobs"

Julian I. Jacobs
Judge

ENTERED: OCT 16 2001

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Case Nos: 02-1132 and 02-1214

YEAGLE DRYWALL COMPANY, INC.,
Appellant in No. 02-1132

AND

VETERINARY SURGICAL CONSULTANTS, P.C.,
Appellant in No. 02-1214

v.

COMMISSIONER OF INTERNAL REVENUE

United States Tax Court Nos.:
00-3908 and 99-2500

SUR PETITION FOR REHEARING

Present: BECKER, Chief Judge,

SLOVITER, SCIRICA, NYGAARD, ALITO, ROTH,
McKEE, RENDELL, BARRY, AMBRO, FUENTES,
SMITH and CUDAHY*, Circuit Judges

The petition for rehearing filed by appellants in the above-entitled cases having been submitted to the judges who participated in the decision of this Court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular service not having voted for rehearing, the petition for rehearing by the panel and the Court en banc, is denied.

BY THE COURT,

"s/D. BROOKS SMITH "
Circuit Judge

Dated: MARCH 05, 2003

*The Honorable Richard D. Cudahy, United States Court of Appeals for the Seventh Circuit, who sat on the original panel, is limited to panel rehearing only.

PERTINENT PORTIONS OF THE TEXT OF FEDERALLY ENACTED STATUTES RELEVANT TO THIS CASE PURSUANT TO SUPREME COURT RULES: 14.1.(f) and 14.1.(i)(v)

The following represents the pertinent parts of various Statutes which are being relied on by the Petitioner and referred to in the body of the Petition. In addition to the following Statutes, Petitioner is hereby including pertinent portions of relevant Internal Revenue Service pronouncement (Rev. Proc. 85-18):

I. PERTINENT PARTS OF FEDERALLY ENACTED STATUTES:

A. 26 U.S.C. Sec. 1366:

"SEC. 1366 PASS-THRU OF ITEMS TO SHAREHOLDERS.

(a). DETERMINATION OF SHAREHOLDER'S TAX LIABILITY.—

(1) IN GENERAL.—In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends... there shall be taken into account the shareholder's pro rata share of the corporation's—

(A) items of income. . .loss, deduction, or credit the separate treatment of which could effect the liability for tax of any shareholder, and

(B) nonseparately computed income or loss...

(b) CHARACTER PASSED THRU.—The character of any item included in a shareholder's pro rata share under paragraph (1) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the

corporation, or incurred in the same manner as incurred by the corporation.
(c) GROSS INCOME OF A SHAREHOLDER.—In any case where it is necessary to determine the gross income of a shareholder for purposes of this title, such gross income shall include the shareholder's pro rata share of the gross income of the corporation.

B. 26 U.S.C. Sec. 3121(d):

"(d) EMPLOYEE.—For purposes of this chapter, the term "employee" means—

(1) any officer of a corporation; or

(2) any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee; or

(3) any individual (other than an individual who is an employee under paragraph (1) or (2) who performs services for remuneration for any person —. . .

If the contract of service contemplates that substantially all of such services are to be performed personally by such individual; except that an individual shall not be included in the term "employee" under the provisions of this paragraph if such individual has a substantial investment in facilities used in connection with the performance of such services (other than in facilities for transportation), or if the services are in the nature of a single transaction not part of a continuing relationship with the person for whom the services are performed. . ."

C. Relevant excerpts from Section 530 of the Revenue Act of 1978 (a/k/a: "The Small Business Protection Act of 1978), P.L. 95-600 as amended by P.L. 96-167, P.L. 96-541, P.L. 97-248, P.L. 99-514, and P.L. 104-188:

"Act Sec. 530(a) TERMINATION OF CERTAIN EMPLOYMENT TAX LIABILITY.—
(1) IN GENERAL.—If—

(A) for purposes of employment taxes, the taxpayer did not treat an individual as an employee for any period, and

(B) In the case of periods after December 31, 1978, all Federal tax returns (including information returns) required to be filed by the taxpayer with respect to such individual for such period are filed on a basis consistent with the taxpayer's treatment of such individual as not being an employee, then for purposes of applying such taxes for such period with respect to the taxpayer, the individual shall be deemed not to be an employee unless the taxpayer had no reasonable basis for not treating such individual as an employee.

(2) STATUTORY STANDARDS PROVIDING ONE METHOD OF SATISFYING THE REQUIREMENTS OF PARAGRAPH (1).—For purposes of paragraph (1), a taxpayer shall in any case be treated as having a reasonable basis for not treating an individual as an employee for a period if the taxpayer's treatment of such individual for such period was in reasonable reliance on any of the following:

(A) judicial precedent, published rulings, technical advice with respect to the taxpayer, or a letter ruling to the taxpayer;

(B) a past Internal Revenue Service audit of the taxpayer in which there was no assessment attributable to the treatment (for employment tax purposes) of the individuals holding positions substantially similar to the position held by this individual; or

(C) long-standing recognized practice of a significant segment of the industry in which such individual was engaged. . ."

"Act Sec. 530(b) PROHIBITION AGAINST REGULATIONS AND RULINGS OF EMPLOYMENT STATUS.—No regulation or Revenue Ruling shall be published on or after the date of the enactment of this Act and before the effective date of any law hereafter enacted clarifying the employment status of individuals for purposes of the employment taxes by the Department of the Treasury (including the Internal Revenue Service) with respect to the emplyment status of any individual for purposes of the emplyment taxes."

"Act Sec. 530(c) DEFINITIONS.—For purposes of this section—

(1) EMPLOYMENT TAX.— The term "employment tax" means any tax imposed by Subtitle C of the Internal Revenue Code of 1954.

(2) EMPLOYMENT STATUS.— The term "employment status" means the status of an individual, under the usual common law rules applicable in determining the employer-employee relationship, as an employee or as an independent contractor (or other individual who is not an employee)."

"Act Sec. 530(e) SPECIAL RULES FOR APPLICATION OF SECTION.—

(1) NOTICE OF AVAILABILITY OF SECTION.— An officer or employee of the Internal Revenue Service shall, before or at the commencement of any audit inquiry relating to the employment status of one or more individuals who perform services for the taxpayer, provide the taxpayer with a written notice of the provisions of this section."

II. RELEVANT EXCERPTS FROM REVENUE PROCEDURE 85-18, I.R.B. 1985-13, 27 (a non-legislative Internal Revenue Service interprative promulgation):

". . .SEC. 3. APPLICATION

.01 "Safe Haven" Rules

There are several alternative standards that constitute "safe havens" in determining whether a taxpayer has a "reasonable basis" for not treating an individual as an employee. . ."

". . .A taxpayer who fails to meet any of the three "safe havens" may nevertheless be entitled to relief if the taxpayer can demonstrate, in some other manner, a reasonable basis for not treating the individual as an employee. In H.R. Rep. No. 95-1748, 95th Cong., 2d Sess. 5 (1978), 1978-3 (Vol. 1) C.B. 629, 633, it is indicated that "reasonable basis" should be construed liberally in favor of the taxpayer. . ."

".09 Definition of Employee

For purposes of section 530(a) of the Act, the term employee means employees under sections 3121(d), 3306(i) and 3401(C) of the Code."